

PROMISCUOUS ELITES

AND

ECONOMIC DEVELOPMENT

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- This paper will focus on the effects of the intertwining of elites on economic growth.
- It focuses on one specific form of intertwining:
- the passage from the bureaucratic elite to the business elite,
- which is termed “pantouflage” in French, “revolving door” in English and “amakudari” in Japanese.
- Indeed, it is frequent that head of bureaucratic agencies, after finishing their bureaucratic job will join the sector they have regulated.

Examples

- Dick Cheney: Defense Secretary
 - SCE (company who got some contracts from the Defense Department)
- Glenn Hubbard: Treasury Department
- KKR Financial Co.
- Larry Summers
- Robert Zoellick

- Ohad Marani
- Yossi Bachar
- Galia Maor

- The revolving door “conflict of interest” can take three different forms:
 - 1. Regulatory Capture
 - 2. Lobbying Capture
 - 3. Abuse of power

- 1. Regulatory Capture
- The regulator will be “captured” by one specific firm, and while strict with the other ones, he will be lenient with this firm in order to be hired by it after leaving office.
- This problem is linked to corruption and is not legally admitted.
- It is about (as Laffont and Tirole, 1996 wrote):
- “Monetary bribes are feasible although not common due to their illegality. More pervasive are the hope for future employment for regulators with the regulated firms.”

2. Lobbying Capture

- The bureaucrat, after leaving office, will be hired by a Lobbying firm and will lobby for companies, client of the lobbying firm.
- This problem is no linked to corruption and is legally admitted.
- The problem is post-public employment

- The bureaucrat will influence former associates to implement or shape policy to benefit the clients of the lobbying firm.
- Conflict of interest, also for Politicians.
- Senator Breaux: “My vote can’t be bought, but it can be rented”
- His clients: Citigroup, Goldman Sachs, GE, AT&T, PhRMA
- Literature: Vidal et al. (2010)

the most referring 2001 Lobbyists in 2009 & 2010

Organization	Number of "Revolving Door Lobbyists Employed in 2009 and 2010"
Citigroup Inc	60
Visa Inc	50
American Bankers Assn	49
Prudential Financial	47
Goldman Sachs	47
Securities Industry & Financial Mkt Assn	43
Natl Assn Real Estate Investment Trusts	39
SLM Corp	36
Private Equity Council	36
Managed Funds Assn	34
JPMorgan Chase & Co	33
Investment Co Institute	33
Genworth Financial	32
Zurich Financial Services	32
Credit Suisse Group	31
Ernst & Young	30

- 3. Abuse of Power
- This conflict of interest arises when “bureaucrats abuse their power to ingratiate oneself with potential future employer”
Transparency International, May 2011
- The conflict takes place during public employment
- Not a legal problem, but ethical.

- This paper develops a model which permit to analyze this type of behavior
- and
- analyzes why the politicians will not try to stop this behavior.

Related Literature

- 1 Inter-connection of Elites (sociology)
- 2. Political Economy and Elites
- 3. Revolving door

- 1. Inter-Connection of elites
- A. The Classical Elite Theory:
- Mosca (1939), Pareto (1935), Michels (1915), Mills (1956)
- They claim that power is concentrated in the hands of a few, despite the numerous elites: the power elite.
- Followed by Hunter (1959), Domhoff (1970), Miliband (1969) Putnam (1977) and Dye (2000)
- Also Bourdieu (1977)
- B. Pluralist Theory:
- Due to numerous types of elites, there is in fact competition among them.
- Dahl (1959), Aron (1960), Parsons (1963), Lipset, Schumpeter.

- 2. Political Economy and Elite power
- Acemoglu and Robinson (2000), Gradstein (2007)
- Engerman and Sokoloff (1997), Justman and Gradstein (1999), Bourguignon and Verdier (2000) and Easterly (2001)
- Brezis and Temin (2008)

3. Bureaucratic elite and revolving door.

- See Stigler (1971), Peltzman (1976), Eckert (1981): regulatory capture.
- Indesirable effects of revolving door (Spiller (1990)) vs. positive (Salant 1995 and Che 1995). Banerjee 1997.

II. The Model

- Why would this type of revolving door (in the form of “Abuse of power”) have effects on the economy?
- Due to:
- The creation of bureaucratic capital
- What is “bureaucratic capital”?

- Bureaucratic capital can take many different forms.
- Two most common ones:
 - 1.
- During his term in office, the bureaucrat develops ties with the lower bureaucracy.
- This stock of relationship will permit him to use it when he works for a firm in the industry he regulates.

- This inter-relation with the permanent civil servants is valuable to the firms in the industry. So, once he has left the public service, the bureaucrat can cash-in on the bureaucratic capital he has accumulated.

2.

- During his term in office, the bureaucrat gives to itself power by the creation of bureaucratic rules, that complicate procedures in the industry.
- As Robertson claims: “Bureaucrats exer their power in a warped way” (Why Bureaucrats make so many regulations?)
- As the enactor of these regulations, the regulator has better knowledge of the ins-and-outs of the system, and, indeed, of any loopholes that might exist.
- This knowledge is valuable to the firms in the industry. So, once he has left the public service, the bureaucrat can cāsh-in on the red-tape he has created.

- In other words, while he is working as a civil servant, he invests in *bureaucratic capital*.
- The rent on this particular investment is harvested only after he passes through the revolving door and takes a job in the regulated industry.
- This behavior maybe not highly ethical, but it does not incorporate any illegality.

- We therefore develop:
- A supply of bureaucratic capital by the bureaucrat
- A demand for bureaucratic capital by the firms
- An equilibrium of this bureaucratic capital

- Will the political elite let the bureaucratic elite use his power and create bureaucratic capital?

•Yes.

- The political elite maximize economic growth.
- In order to get the highest rate of growth possible, the political elite will permit the creation of bureaucratic capital.
- The reason for this result is that there is some complementarity:
 - quality of bureaucrats and
 - creation of bureaucratic capital

- High quality bureaucrats are needed for reaching economic growth.
- But
- in order to hire bureaucrats of high quality, the government has to pay them higher income.
- Since wages are not very high in civil service, the way to propose higher income is to let the bureaucrats accumulate bureaucratic capital, which will permit them to cash in, in the future.

- So the creation of bureaucratic capital permits to have bureaucrats of higher quality.
- Therefore, the political elite will not choose a corner solution.

and

- **the optimal amount of bureaucratic capital is not zero.**

- Therefore, despite caring about economic growth, the political elite finds it optimal to let the bureaucratic elite create these redundant laws, which are nuisance to the economy.
- So this paper explains the fact that the political elite permits “bureaucratic capital” to be created despite its negative effect on the economy.
- This is the first result.
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- The second result of this paper is that the market equilibrium will not bring the economy to the highest rate of growth possible.
- At the point of market equilibrium, we get that the bureaucratic elite is of higher quality than optimal, but creates more bureaucratic capital than the optimum for the economy.

The Framework

- A growth model in which economic growth is due to the development of new intermediate good firms (Romer, 1990.)
- Final good, Y and Research and Development, R .
- The market for “bureaucratic capital”

The Different Sectors in the Economy

- 1. The rate of growth in the economy
 - 2. The behavior of the political and bureaucratic elite
 - 3. The production sector
 - 4. The intermediate-goods sector
 - 5. The research sector
- The equilibrium

II. Supply and Demand of Bureaucratic capital

- The supply of BC will be by the bureaucratic elite
- The demand of BC will be by the business elite which own intermediate good firms

II. The Supply of BC

- Bureaucrats maximize the present value of their income.
- The bureaucrat can develop regulations that complicate procedures in the industry. /(can develop relationship).
- As the enactor of these rules and regulations, the regulator has better knowledge of the ins-and-outs of the system.
- This knowledge is valuable to the firms in the industry, and thus, once he has left the public service, the regulator can cash-in on the red-tape he has created.

- The bureaucrat works N years, divided into two periods.
- During the first period, t_1 , he works as a regulator. During this period, the regulator creates BC which requires effort of size E .
- We assume that the amount of capital is a function of the amount of effort invested, and assuming a simple concave function, we have that the bureaucratic capital of regulator i is:

$$H_i(E_i) = [(1 + \gamma)E_i]^{1/1+\gamma} \quad \gamma > 0$$

- During the second period of length, τ the bureaucrat works in the industry that he regulated.
- He receives the regular wage, plus a rent which is equal to the "bureaucratic capital", H he has accumulated.
- In consequence, the total income of the bureaucrat is:

$$V_i = \Omega - E_i + \tau q H_i (E_i)$$

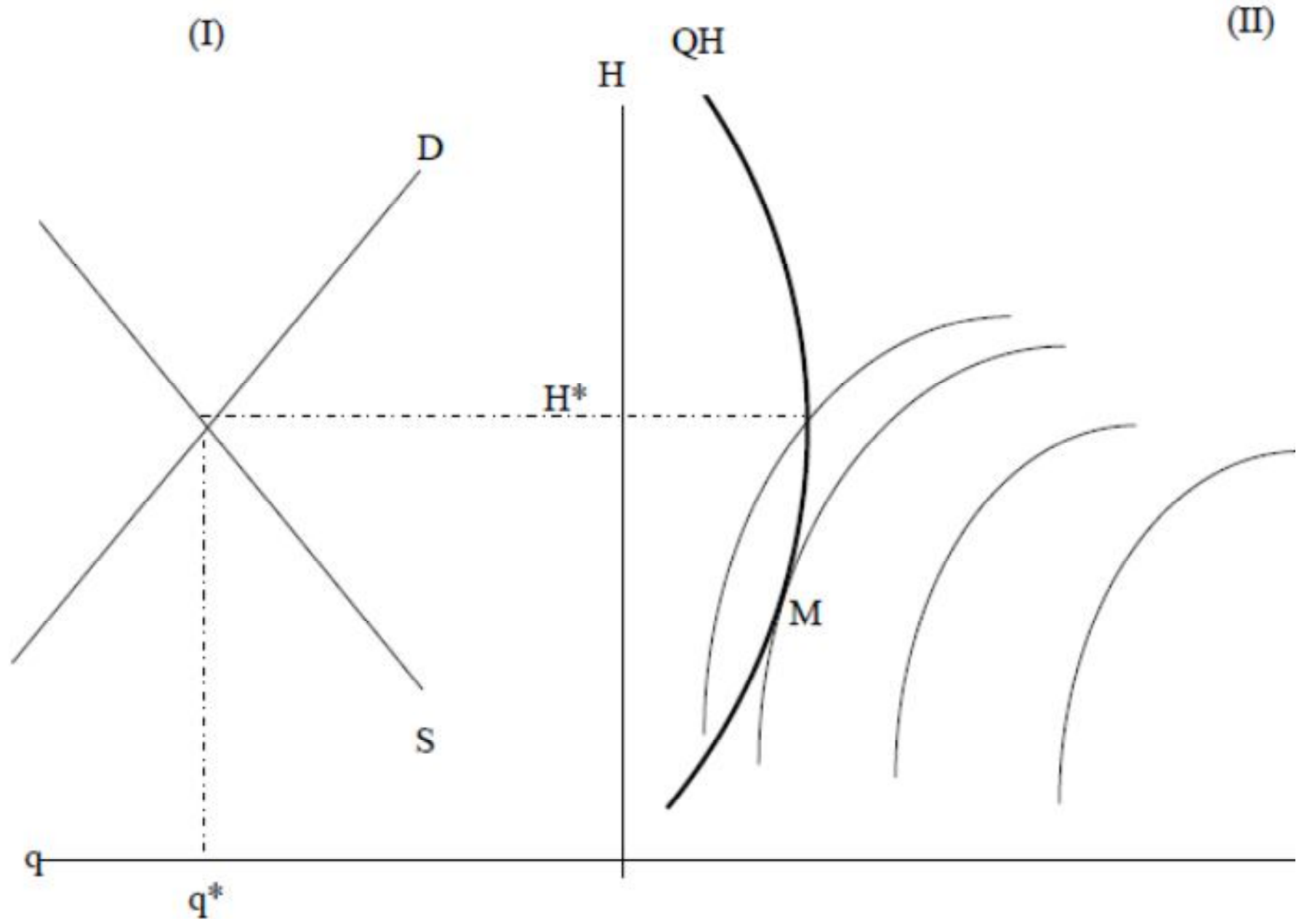
where Ω is the earnings not related to the creation of BC, and he sells the BC at price q for a number of τ years.

- This equation can be rewritten as a function of the BC :

$$V_i = \Omega - \frac{H_i^{1+\gamma}}{1+\gamma} + \tau q H_i$$

The optimal amount of supply of BC is:

$$\hat{H}_i = (\tau q)^{1/\gamma}$$



IV. The demand for BC- **The Intermediate-goods sector**

- The intermediate-goods sector consists of monopolists who own a patent bought from the R&D sector, and produce the capital goods, x that are sold to the final-goods sector, Y .
- They have two types of costs.
- The first one is the amount of capital, k they use.
- and as Romer, we assume a simple production function

$$x_j = k_j$$

- The second one is that they have to pay for the bureaucrat they will take on the board.
- Why will they do that?
- When a firm j hires a bureaucrat, the production of output j becomes more efficient.
- This is so, because the regulator has a better knowledge of the system and of the loopholes that exist.
- But, the effect of this bureaucratic capital in firm j depends on the amount of bureaucratic capital of other firms, since what matters is the relative effect of the regulator.

- In fact, it depends on the relative amount of bureaucratic capital by the different regulators of the different sectors.
- So the production function for an intermediate good firm is:

$$x_j = k_j \left(\frac{H_j}{H_a} \right)^\phi \quad \phi > 0$$

where H_j is the amount of bureaucratic capital produced by the regulator of firm j ,

and H_a is the average amount of bureaucratic capital owned by the other firms.

- So the profit maximization for an intermediate good firm is:

$$\text{Max } \pi_j = p_j(x_j)x_j - rk_j - qH_j$$

which becomes:

$$\text{Max } \pi_j = p_j(x_j)x_j - rx_j \left(\frac{H_j}{H_a} \right)^{-\phi} - qH_j$$

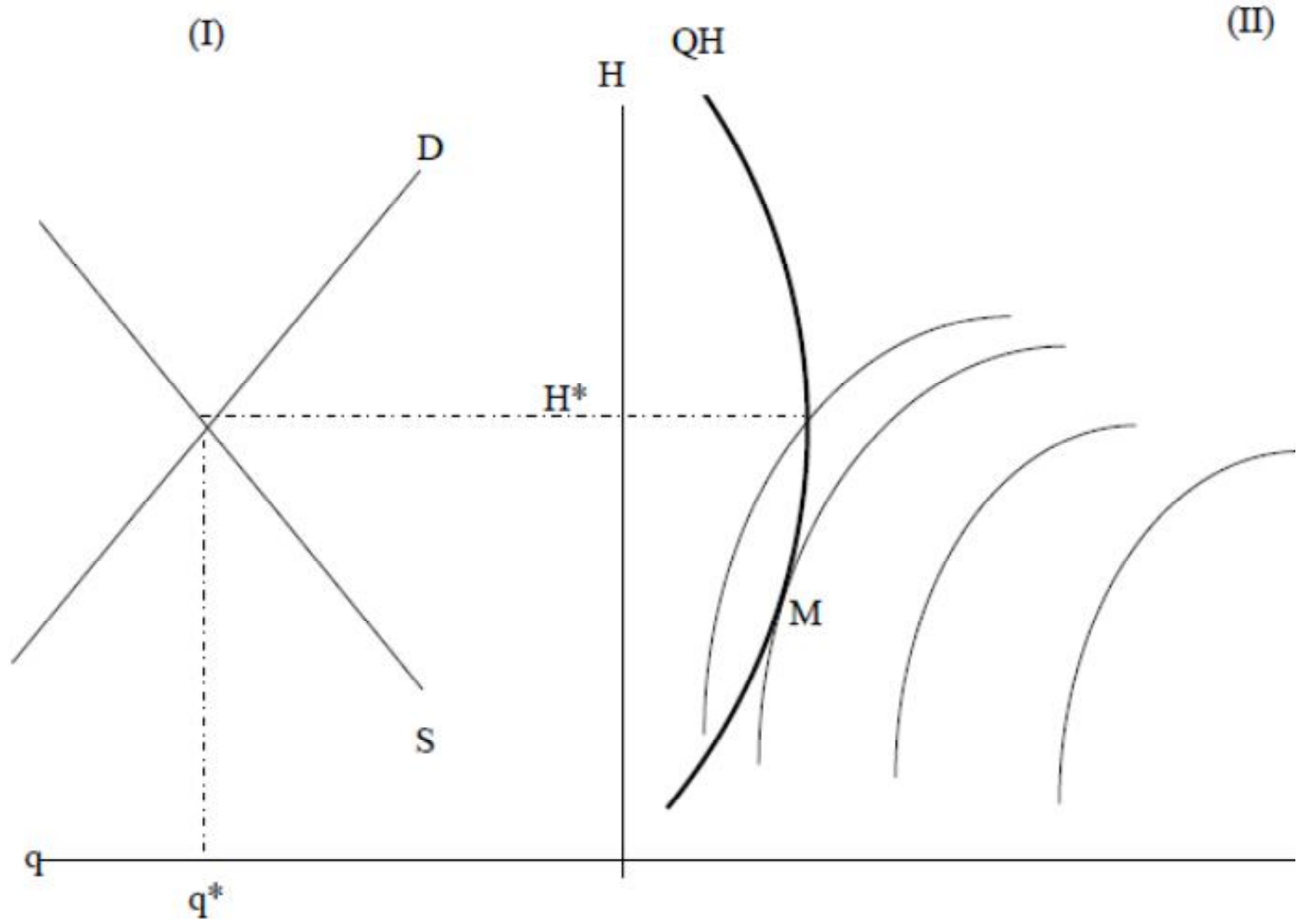
- Taking the FOC for maximizing profits, we get:

$$H_j = H_a = \frac{\phi rK}{qA}$$

- This is the demand for BC (in a symmetric equilibrium).
- where

$$K = \int_0^A k_j dj$$

- This is the demand curve for BC:



III. The production sector

- The economy produces one final homogenous good, which exhibits constant returns to scale. This good is produced with labor and intermediate goods, so that:

$$Y = L_y^{1-\alpha} \cdot \int_0^A x_j^\alpha dj$$

- The firms involved in the production sector are maximizing profits:

$$\text{Max } L_y^{1-\alpha} \cdot \int_0^A x_j^\alpha dj - w_y L_y - \int_0^A p_j x_j dj$$

The political Elite

- Models of political economy put as the main goal of politicians to be elected again, which take into account the well-being of citizen.
- In consequence for matter of simplicity, I assume that:
 - the political goal of the elite is to maximize the rate of growth of the economy in order to be reelected.
 - They choose the regulator among a pool of candidates.

- But candidates for the regulatory post are heterogeneous, and have different abilities, which make them more effective as regulator.
- 1. We assume that the ability of the regulator affects economic growth:
- 2. I show that attracting a higher ability regulator requires that the lifetime income earned in regulation, V , be greater.

$$\dot{A} = \delta(Q_i) L_r A$$

- \dot{A} is the number of new inventions
- L_r is the size of the labor force in the R&D sector;
- A is the amount of inventions/machines already in existence
- δ is a positive parameter function of the quality
- Q is the quality of the bureaucrat i
 - The rate of growth, g is:

$$g = \frac{\dot{A}}{A} = \delta(Q_i) L_r$$

- Candidates are heterogeneous in their ability, and have also the opportunity to work in the alternative sector in which income depends on the ability of the person.
- When ability affects the productivity of a person, then wages are not equal for all: “workers’ wage is an increasing function of his ability”.
- without loss of generality, we assume the following form: where

- (18)
$$W_s = \xi Q_s$$

Where W is income in the alternative sector and Q is the ability.

- Since quality of the regulator affects economic growth, the political elite want to choose the regulator with highest ability possible
- The political elite know that the reservation wage of the potential bureaucrat is given by (18) and therefore the choice faced by the political elite is to hire a bureaucrat with ability such that:

$$Q_i = \text{Max} \langle Q_s \mid \xi Q_s \leq V_s \rangle$$

- and therefore:

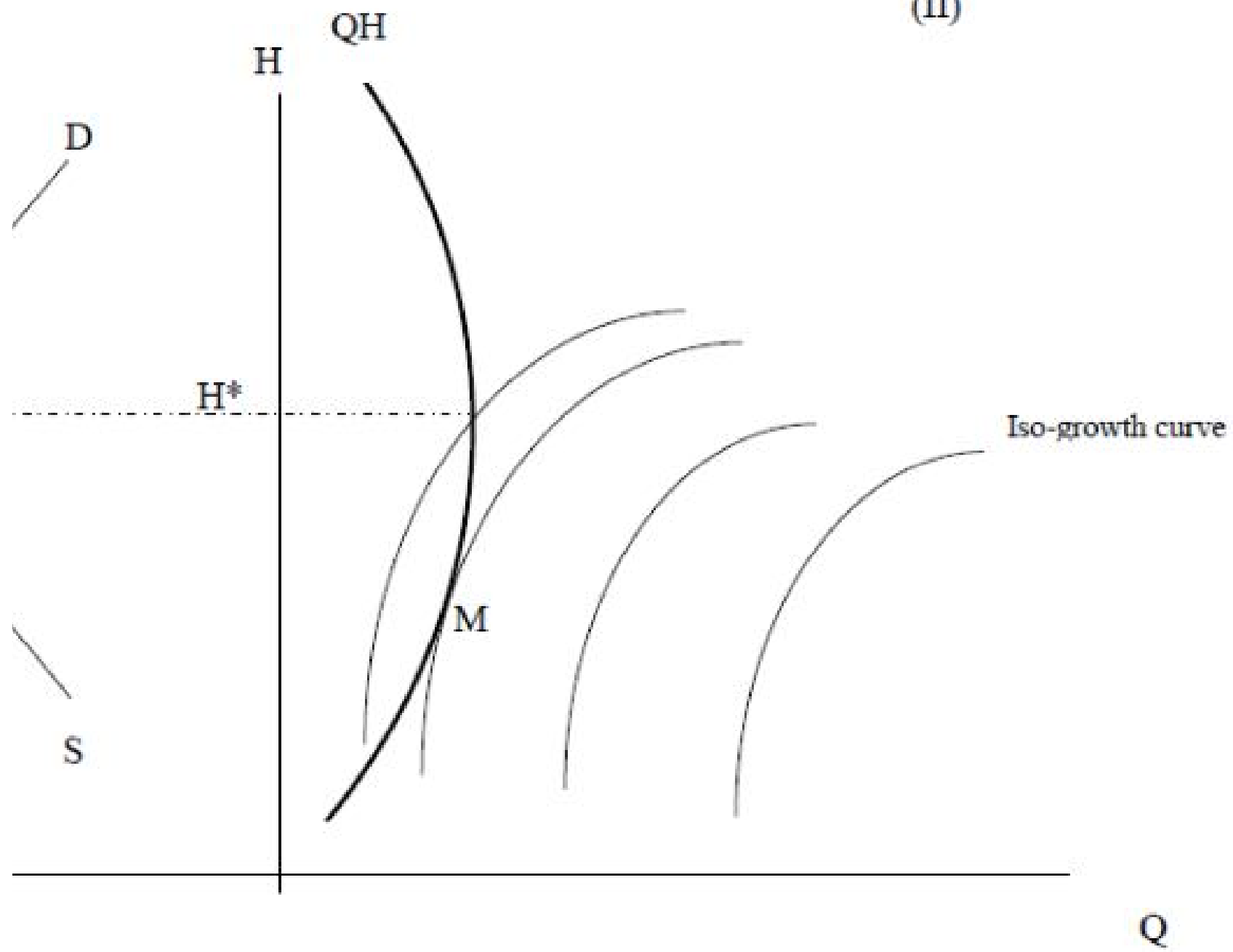
$$Q_i = \frac{1}{\xi} V_i$$

- The relationship between ability and amount of bureaucratic capital faced by the political elite and the public is:

$$Q_i = \frac{1}{\xi} \left[\Omega - \frac{H_i^{1+\gamma}}{1+\gamma} + \tau q H_i \right]$$

- This equation describes the trade-off faced by the political elite:
- Appointing a regulator with higher ability means letting him accumulate a higher amount of bureaucratic capital.
- This equation is therefore the production possibility frontier between bureaucratic capital and ability faced by the political elite.

(II)



I. The rate of growth in the economy

- L, K constant. The factor that leads to growth is the increase in the number of new technologies, A.
- This model is based on Romer's framework, in which the number of new inventions, A is a function of (1) the size of the labor force in the R&D sector, and (2) the size of the technological already in existence, A (the usual externality of spillover effects).
- In this framework, we add an externality of the ability of the bureaucratic elite. We assume that the higher a regulator's ability, the more effective his regulation

V. The Research Sector

- In the research sector, new designs for new machines are discovered.
- The inventor can patent his invention and sell the exclusive rights to produce a new capital good.
- From the asset pricing arbitrage equation we get that:

$$rP_r = \pi + \dot{P}_r$$

- Where P_r is the price of a new-design patent.

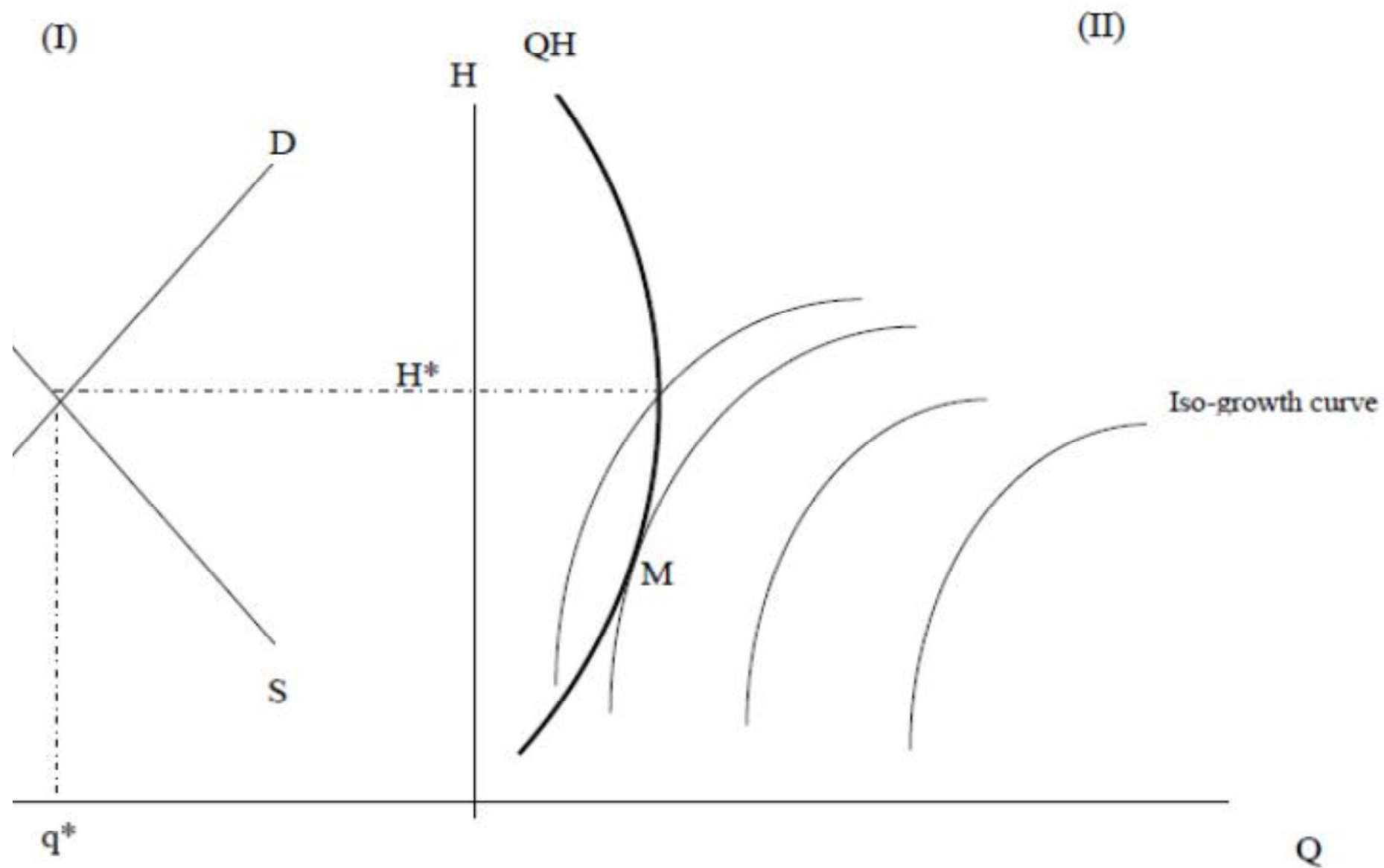
VI. Determination of the Equilibrium and of the Rate of Economic Growth

- The Equilibrium in the production sector is such that the rate of growth is:

$$\gamma = \delta(Q)[\bar{L} - L_y] = \delta(Q)\left[\bar{L} - \frac{r}{\alpha\delta(Q)} - \frac{H}{\alpha(1-\alpha)\beta}\right]$$

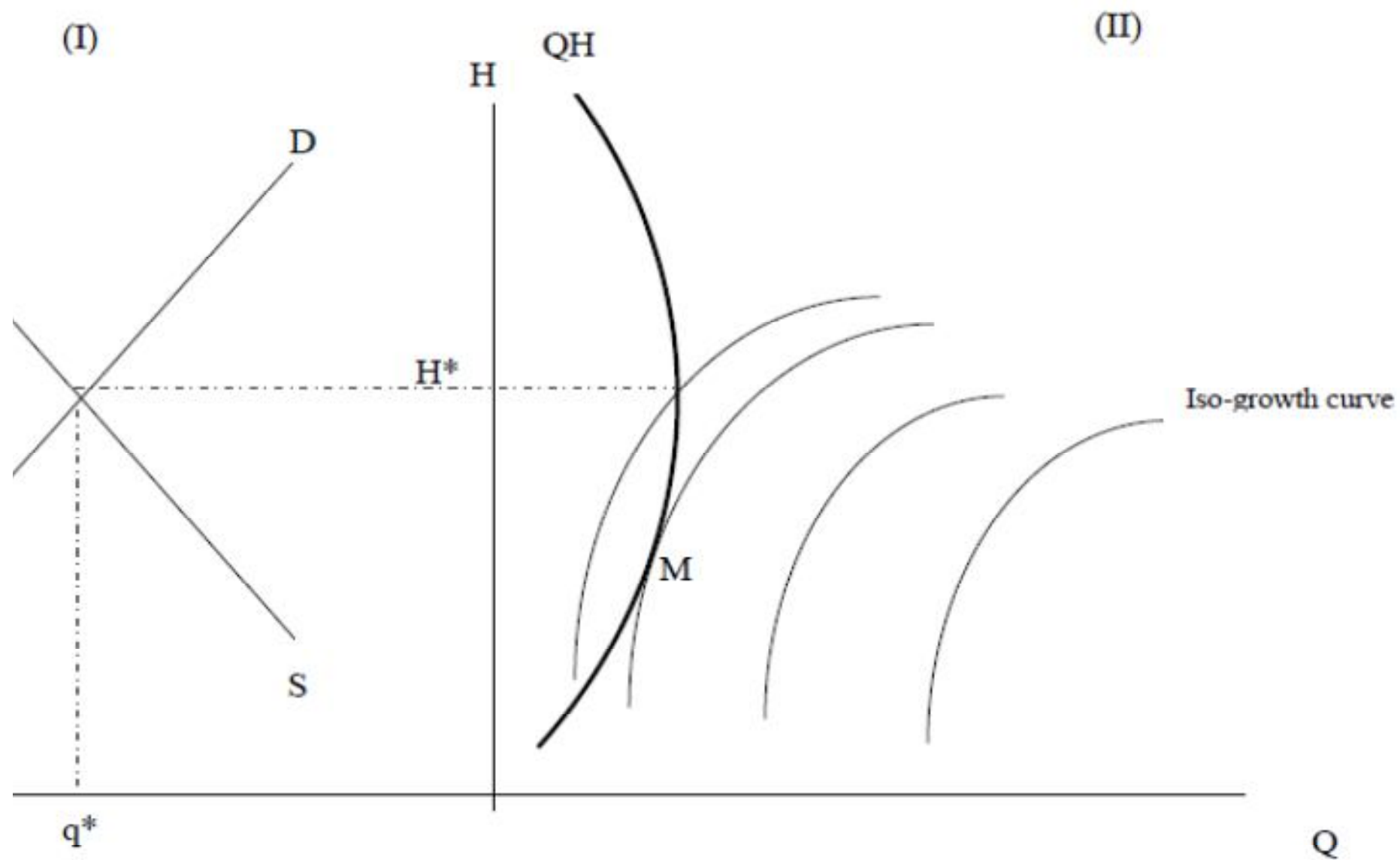
- The rate of growth is a positive function of Q and negative of H.

Figure 1. Supply and Demand of Bureaucratic Capital, and the Trade-off between Quality and Bureaucratic Capital



- In the following proposition, we present the optimal amount of bureaucratic capital for the economy.
- **Proposition 1**
- *The optimal amount of bureaucratic capital is positive. The economy has an interest that the bureaucratic elite create redundant and wasteful regulations.*

Figure 1. Supply and Demand of Bureaucratic Capital, and the Trade-off between Quality and Bureaucratic Capital



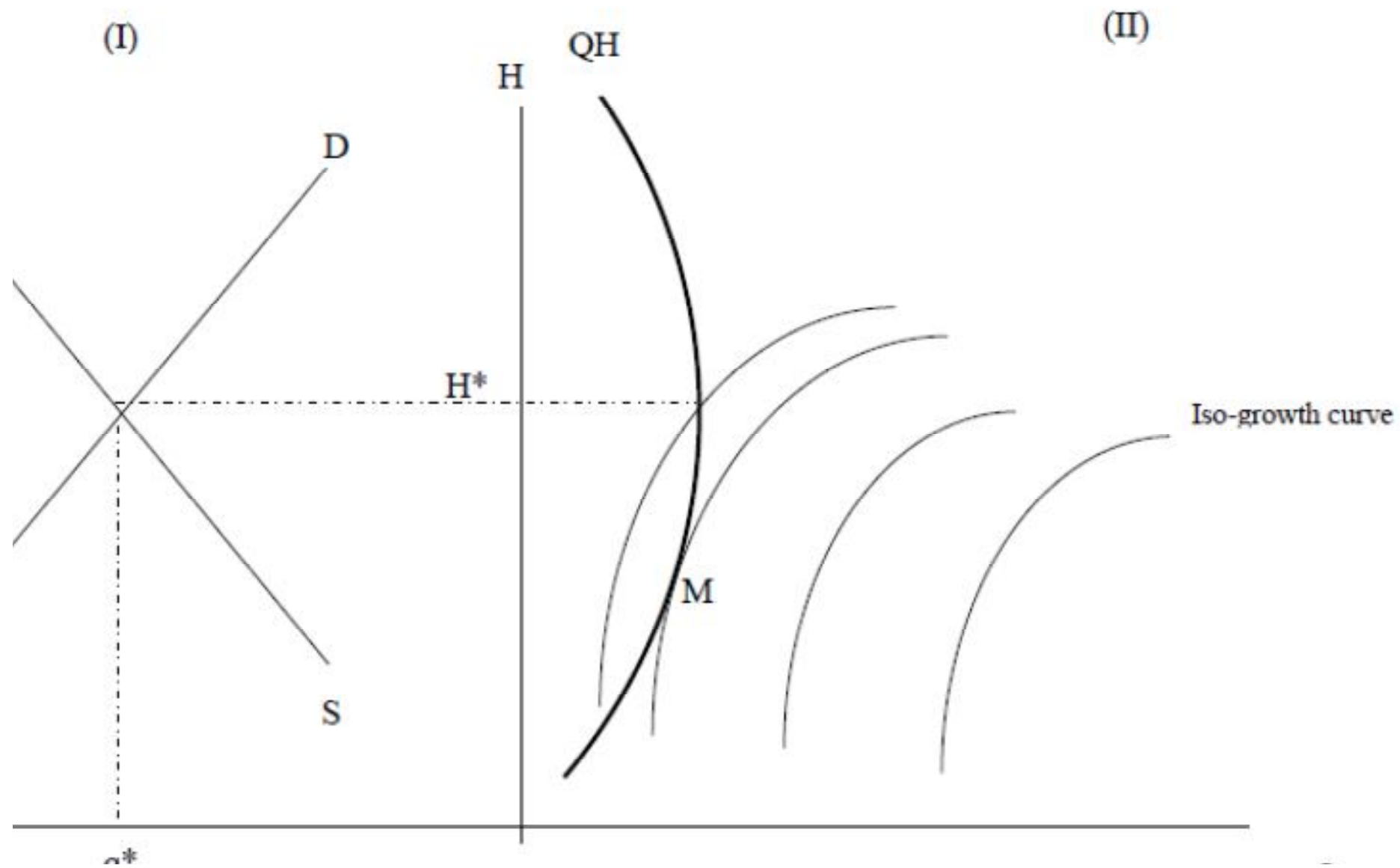
- In other words,
- Bureaucratic capital is a social waste, but still necessary in order to have good bureaucrats.

- Although point M is optimal for the economy, is there a way that the system will bring the economy to such a point?
- No.

Proposition 2

- *The amount of Bureaucratic capital, H chosen by the bureaucratic elite is higher than the amount the political elite would choose.*

Figure 1. Supply and Demand of Bureaucratic Capital, and the Trade-off between Quality and Bureaucratic Capital



● Conclusion

- This paper has presented a simple framework for analyzing the behavior of the bureaucratic elite.
- It has focused on a specific form of intertwining among elites, which is the revolving door.
- A priori this habit seems to be negative for the economy, since the bureaucrat have some sort of power on the economy.
- This paper shows that it also has a positive effect on the economy.

- This form of intertwining may permit to have bureaucrats of higher ability, which is important for the economy.
- Due to this relationship between elites, our economies tend to have redundant bureaucratic regulation. This is a cost to pay to reach a higher rate of growth.
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- The conclusion from this small model is that the possibility of *pantouflage* leads the system to have bureaucrats with very high ability.
- The equilibrium is at a point in which the ability is at the maximum.
- But, the political elite would have preferred less red-tape even at a point of having less ingenious bureaucrats.
- One possible solution to reduce the amount of bureaucratic capital could be to pay the bureaucrats more,
- but increasing the payroll of bureaucrats is certainly not a good solution. ...especially these days!